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LoopCo

More Local Competition,
Less (and Smarter) Regulation.

February 25, 1998

Secretary
FCC
1919 M Street
Washington, DC 20554

Re: LCI PETITION FOR DECLARATORY RULING CONCERNING BELL OPERATING COMPANY ENTRY INTO IN-REGION LONG DISTANCE MARKETS, CC DOCKET NO.98-5

Dear Mr. Secretary:

The policy centerpiece of the LCI Petition, like that of the LoopCo proposal, is right on point. Unless the Commission takes measure to restructure the ILECs to eliminate their existing conflict of interest, no meaningful progress will be made in introducing meaningful local competition to either residences, or the majority of all business customers.

As long as the ILECs provide retail services to end users, while providing unbundled network elements (upon which the ILEC's competitors must rely for entry), the ILECs have no meaningful long term incentive to provide unbundled elements in a responsive manner to their retail competitors. If we continue with the currently flawed structure, either one of two scenarios will emerge. Either this Commission and each of the state PSCs shall be in the business of micromanaging local competition, or the Commission and the PSCs will "give up" and let the ILECs dominate the local markets leaving only fringe competitors which serve specialized niches. In either case, the promises of the Telecommunications Act of 1996 will not have been met, namely, less regulation and robust competition.

The recent mergers and proposed mergers of Bell Atlantic/NYNEX, and SBC/PacBell/SNET are multibillion dollar bets by the management of these companies that this Commission and the PSCs neither have the courage or conviction to implement policies that present a substantial risk to the ILEC's dominance. The financial markets agree in their rewarding of these firms with higher stock prices than ever before. The bets are that the ILECs are at no material risk to their current status (a privilege that no competitive market endows

upon any participant), and that the ILECs will enjoy the best of all monopoly profits, the "quiet life," for the foreseeable future.

Its time to think and regulate smart. This means creating a market structure where all retail competitors are treated equally -- by any measure.

Comparison of the LCI and LoopCo Plans

Whether one adopts the approach of LCI or the LoopCo proposal, the objective of both plans is to sever the core of the ILEC's natural monopoly from its retail operations, and that such severed wholesale operations be operated apart from that of the ILEC's retail operations. That severed wholesale arm would be limited to selling to certified LECs those critical unbundled network elements that all LECs require and for which those competing LECs have no reasonable alternative ubiquitous supplier. The following table summarizes the substantive differences between the LCI and LoopCo Plans:

Issue	LoopCo Proposal	LCI Proposal
Wholesale Firm's Name	"LoopCo"	"NetCo"
Wholesale Firm's Customers	Only Certified LECs	Ultimately only certified LECs; but, initially grandfathered local end users
Wholesale Firm's Facilities Retained From Original ILEC	Loops (including inside wiring), Central Office Building (for offering collocation to others), transit switch (for transiting between all LECs), white pages, and 911 services	All existing facilities of the ILEC, including all facilities possessed by LoopCo [loops (including inside wiring), Central Office Building (for offering collocation to others), transit switch (for transiting between all LECs), white pages, and 911 services], plus Central Office Switches, interoffice trunking, tandem switches, and trunks to other carriers.
Retail Firm's Facilities Retained from Original ILEC	Central Office Switches, interoffice trunking, tandem switches, and trunks to other carriers.	None.

Effect on End User's Service and which ILECs	None. Tier I ILECs	End user must switch to another carrier when the end users wishes to upgrade its service or otherwise change its service (e.g., move). RBOCs only.

The major difference between the LoopCo and LCI approach is that the LoopCo approach takes a more long term view of where competition will or will not occur, and the LoopCo approach has absolutely no effect on retail end user's purchase patterns (i.e., the end user's of the ILEC remain the end user's of the ILEC and are not forced off their existing retail carrier, as they ultimately are with the LCI plan). The LoopCo plan recognizes that there will be little or no competition in the facilities portion of the local telephone market because the economies of scale are substantially in favor of the incumbent provider and the costs of installing new loop plant outweigh the potential risk adjusted returns for most of the market. Thus, the LoopCo proposal requires that this core source of long term monopoly power of the ILEC (i.e., the local loops and central office buildings connected to them) be severed and remain in a stand alone entity whose business focus will be on providing local loops to any and all certified LECs. The advantages of having the severed LoopCo pursue a focused business strategy are substantial from both a business and regulatory policy viewpoint:

First, investors will find substantial interest in LoopCo because investors like firms who have a core competence and can focus on that core competence. Recent illustrations of such successful focused strategies are the divested Lucent (from AT&T) and AirTouch (from PacBell). Investors realize that "conglomerates" of telecommunications properties will manage their properties to maximize overall corporate returns, not the returns of individual properties. Thus, not surprisingly, the existing vertically integrated ILECs view local loops as inputs to their production of their bundled retail product. From an overall financial and management perspective, it would be irrational for the ILECs to focus on creating a desirable stand-alone local loop product line because the only beneficiaries of such a line of focused loop products would be the competitors to the ILEC's retail services. The bottom line is that a vertically integrated ILEC purposely and quite rationally focuses its efforts on making an attractive -- relatively high margin, but higher risk -- retail service, and an unattractive stand alone -- relatively low margin, but lower risk -- local loop product. This is a result that certainly counters the goals of the Telecommunications Act and also results in suboptimal deployment of the local loop plant in the context of the overall telecommunications industry and investors.

Second, regulators should favorably view the LoopCo approach because the reconfiguration of the ILECs will subject every portion of their retail offerings to meaningful fair competition,

almost from the date of the reorganization, and also simplify the products and that need exhaustive regulations -- namely, only the products of the LoopCos. With regard to all separated retail portions of the ILECs, which would now be on an equal footing with other LECs, the PSCs and the FCC to depend primarily on market forces for setting their retail prices in all markets. USF would also be simplified because only the LoopCo-provided loops or other qualifying loop-only providers of loops would be targets of subsidies, and the sources of the revenues for the USF would be all local telecommunications retail service offerings of LECs, as it is done today. Moreover, because end users would not be displaced in any way by the implementation of the LoopCo proposal, there would not be a public policy backlash as there was with the MFJ (which required end users to buy from two carriers where, before, they only had to purchase from one).

The LCI proposal takes a more near term view. The LCI proposal assumes that the kind of local switching that exists today is something that can be obtained only from the ILEC. While that is true given the current arrangement, it would not be true under the LoopCo proposal. Under the LoopCo proposal, the ILEC would be required to purchase collocation under the same terms and conditions as all other CLECs (who can purchase their own CO switches) from the LoopCo to collocate their local switching in the central office. No preferences in the placement of ILEC local switching in the LoopCo central offices would be allowed, as LCI properly recognizes exists today. Similarly, interoffice trunking is relatively easily obtainable today in most areas and, with the same collocation requirements for ILEC retail as well as CLEC retail facilities, would place interoffice transmission of CLECs on the same footing as that of the ILEC's today.

In sum, the LoopCo proposal is simpler primarily because it takes a longer run view of where the industry is heading and where competition is sustainable. Regardless, the LCI Proposal, albeit more of a near term compromise, is far better than that which exist today and will result in far more competition than that which can be envisioned under any realistic trajectory based on the current market structure. Its time for competition, and its time for the local loop plant to be liberated to serve towards the development of meaningful, robust competition for all end users and the development of the kinds of telephony/date services that the industry only dreams of today.

A copy of a recent article detailing the benefits of the LoopCo proposal is attached for the Commission's consideration.

Sincerely,

R. Morris
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A Proposal to Promote Telephone Competition: The LoopCo Plan

by Roy L. Morris

The LoopCo Plan, which uses market mechanisms to promote competition, is the best approach to restructuring the telecommunications market, say its proponents, who object to the requirements and to-date implementation of the Telecommunications Act of 1996.

Deregulation of a highly regulated, highly concentrated industry is a difficult task that requires some threshold determinations. If you make the wrong determinations, which take you down the wrong path, well-intentioned deregulation becomes a regulatory quagmire. This is what has happened in the drafting and implementation of the Telecommunications Act of 1996. What is the approach that the Act and the resulting regulations should have taken in order to successfully create a competitive local exchange market? Based upon actual interconnection experience since the passage of the Telecommunications Act and the FCC's interconnection rules, the "LoopCo Plan" proposal is before the Federal Communications Commission (FCC).[1] The LoopCo Plan would split local loops from the remainder of the local exchange company, which would become an unregulated (or lightly regulated) utility. It is not too late to implement the LoopCo plan, and the FCC has the requisite authority to do so on its own initiative and, in turn, to dismantle the regulatory maze that the Telecommunications Act of 1996 has generated. The LoopCo plan would benefit not only competition, but also the shareholders of incumbent local telephone companies.

Command and Control vs. Market Structure

Identifiable long-term sources of market power among incumbents in a regulated market must be isolated and made competitively neutral (i.e., "neutralized") in order for meaningful competition to develop in all sectors of the market. These core sources of market power are typically large economies of scale and/or barriers to entry that make large scale, *sustainable* entry by new firms impossible in the foreseeable future. If the source of market power is not neutralized, the incumbent who has control and/or possession of the

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source of that market power will continue to dominate and control overall entry and competition in its respective markets.

In the telecommunications industry, there are two core sources of long-term market power. First, there is the number coordination function (i.e., the assignment and management of the telephone numbering plans). Historically carried out and controlled by incumbent telephone companies, number coordination shares some characteristics with power pool administration in the power field. [2] It is an activity that requires that only one entity perform the task in each region. The FCC has already taken steps to eliminate this source of market power by shifting number coordination away from incumbent telephone companies to independent, third parties and by implementing number portability that allows telephone customers to switch local telephone companies without the need to change their telephone numbers, suffer from degraded service, or lose any features.[3]

The second source of long-term market power in the telephone industry is the local distribution network—which is similar in its economics to the local electric transmission network. Economies of scale dominate the economics of local distribution to most telephone customers, resulting in the potential risks of building a redundant ubiquitous local transmission network by a new entrant outweighing returns for the potential entrant.[4] The local distribution network is made up primarily of the local loops[5] (primarily long wires) connecting each telephone customer to the local central office.[6] Local loops are typically provisioned using a network of lengthy and bulky cables on telephone poles along the street or in ducts placed underneath the street. A local loop must often be wired into each dwelling and business location.

Like the local electric distribution network, local telephone distribution networks are subject to large economies of scale (e.g., much of the cost of a loop is associated with installing and maintaining the cable in which the wires are contained and the structures needed to support that cable) and high barriers to entry (e.g., telephone poles and underground ducts have a limited capacity for holding cables, and obtaining rights to wire into a building is often difficult and expensive, if not impossible). The costs of across-the-board duplication of the local telephone distribution network are astronomical (running into the billions of dollars), and the risks associated with any attempt to do so would not be compensated by adequate returns.[7]

The market power that the local distribution network provides the incumbent local exchange carriers (ILECs) is the focus here. Laws and regulations generally use two approaches to open up monopoly markets to competition. The first approach is what will be termed a "command approach." Namely, a law is passed and/or regulations are adopted that command the incumbent to perform an economically unnatural act (i.e., an act that the ILEC does not consider to be in its best interest) on a prospective, ongoing, and repetitive basis.

In the case of the Telecommunications Act of 1996,[8] ILECs[9] were commanded to sell unbundled local loops and central office space to competing firms at a price that would be charged by a competitive supplier of these facilities. As might be expected, ILECs have—intentionally or unintentionally—done everything possible to make their unbundled local loops and central office space as unattractive and unusable as possible— mainly because they have no economic incentive (nor can one be imagined) to sell these essential items to their new entrant *retail* competitors. The logic of the Telecommunications Act defies common sense because it asks ILECs to sell something that would cause them in one market (the wholesale unbundled loop market) to lose market share and profits in their mainstream retail local and long-distance service businesses—a very unnatural act for any for-profit company.

The second, alternative approach to dislodging monopoly power from ILECs is to isolate the source of the monopoly power and to make the monopoly effects of its offering competitively neutral to the entire industry. By making slight modifications to the market structure and/or the incumbent's corporate structure, the negative incentives of the marketplace can be replaced by positive incentives. It is this market structure approach that is taken by the LoopCo Plan.

As explained more fully below, the LoopCo Plan is wholly within the FCC's jurisdiction and can be adopted using sound case law that has been well established in earlier FCC proceedings and approved by the appellate courts. This is in contrast to the FCC's most recent regulation-intensive efforts to follow the "command approach" in the Telecommunications Act, which seeks to force ILECs to offer their local distribution and central office space to their competitors. Those FCC regulations implementing the "command approach" were, for the most part, overturned by a series of decisions by the Eighth Circuit of the U.S. Court of Appeals.[10]

LoopCo Benefits ILEC Shareholders

A LoopCo spin-off would and should leave the shareholders of ILECs whole.[11] Moreover, a spin-off should actually leave ILEC shareholders better off. Today, modern finance and management strategists strongly believe that organizations that "focus" their business in a few areas return better shareholder value than those that attempt to create a portfolio of businesses within a single firm. Focusing on a specialized area allows a firm to optimize the sale and delivery of goods and services in the specialized area in which it has developed its core competency. Also, focus allows a firm to be more flexible and responsive in selling and delivering those goods and services as markets evolve.

Thus, the most successful firms in dynamic industries today often sell primarily wholesale or retail versions of services or products, and not both, or they focus on selling components of finished products, but not both, because their core competencies are in one area. These firms have learned that attempts to enter other areas detracts from or causes conflict with their primary area of business. This distraction and conflict can cause the firms to loose their footing due to the dynamic changes in these business segments.[12] For instance, in the telecommunications industry, when the Bell System was split up into functional areas in 1984, the total value of shares of all of the resulting more specialized entities increased in value—outperforming other firms that remained vertically integrated and diversified in similar industries. Similarly, when AT&T recently spun off its manufacturing and computer divisions, the overall value of the shares of the resulting firms increased. Another example is PacTel's spin-off of its cellular properties. In fact, it is difficult to find an example of a firm whose total sum of itself and its spin-offs did not outperform the original firm. Thus, simply from a business performance viewpoint, companies with focused strategies tend to outperform and provide greater returns to their shareholders.[13]

Like Intel, LoopCos would be focused on a "LoopCo Inside" strategy, seeking to promote the use of their loops in the telecommunications products of retail telecommunications service providers. Similar to Compaq, post-spin-off ILECs would focus on direct retailing of final products with their common ILEC brand using some resold inputs from others, including LoopCo loops and inter-region long distance of other carriers.

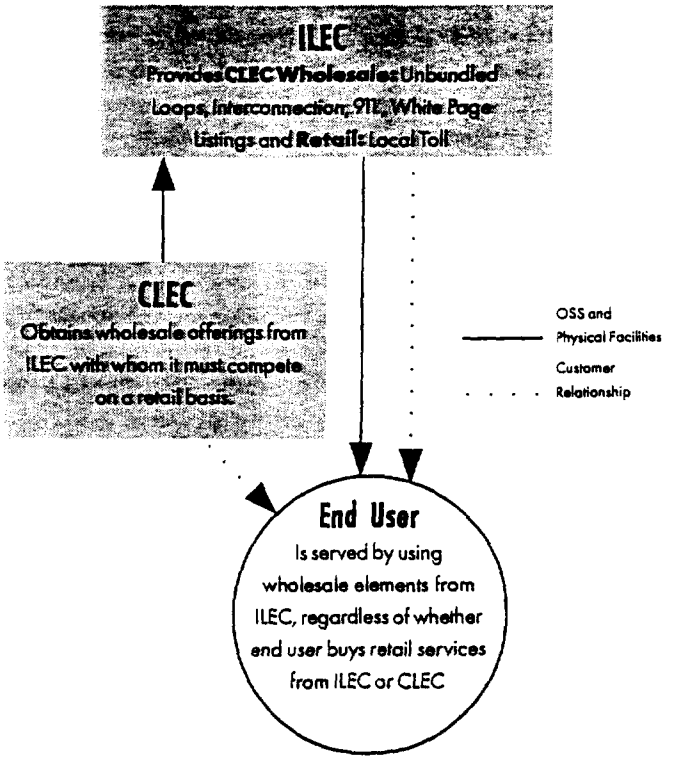
As an investment vehicle, spin-offs are more valuable for portfolio investors. Professional investors prefer to make their own diversification mix decisions by investing in "pure plays" in certain markets and submarkets, rather than by purchasing a single company which has—in effect—made these "mix" decisions for its shareholders. Thus, with focused companies such as LoopCos and LoopCo-less ILECs as investment vehicles, an investor can choose to have a less risky portfolio weighted towards local distribution by purchasing a larger proportion of a LoopCo's stock. Similarly, if a riskier portfolio is desired, the investor could purchase a larger proportion of LoopCo-less ILEC stock. For this flexibility, investors are willing generally to pay higher overall share prices for post-spun-off firms than for their pre-spun-off ancestral conglomerates.

Robust Competition, Less Complex Regulation

By eliminating conflicts of interest and substituting incentives that make transactions among carriers a non-zero sum game, the LoopCo Plan will lessen the need for regulation to promote competition. The LoopCo proposal addresses most of the issues that have confronted and confounded the slow development of meaningful competition in the local markets. Where market forces (i.e., profit-maximizing needs of all play-

Figure 1

Current Structure Requires CLEC to Deal With ILEC



ers) drive competition, as is the case with the LoopCo Plan, regulation need not be burdensome or complex. This is in stark contrast to the current "command regulation" regime, where hundreds of pages of rulemakings and almost an equal number of rules are needed to attempt to control in detail the behavior of the vertically integrated ILECs.

Each LoopCo would be publicly owned and could not be an affiliate of any certified LEC. If the LoopCos were jointly owned or affiliates of the ILEC, an inherent preference or bias of the workers and managers would exist towards improving or otherwise benefiting the ILEC. The importance of this requirement cannot be overemphasized, because workers and managers know who pays their salaries and that overall performance of their companies determines the value of their stock options, ESOPs, and 401(k) stock matching.[14] In sum, this separation is required in order to assure that a LoopCo has the proper incentives for itself and its core business, rather than the possibility of a compromise in its operations that would benefit the retail operations of the ILEC.

The elimination of the conflict by the LoopCo proposal, as well as the financial, managerial, and operational separation of the LoopCo from the ILEC, also lessens the need for detailed regulation and increases market-based drivers for robust competition. Without the conflict that exists under the current scheme, the LoopCo proposal makes transactions between the local distribution provider (LoopCo) and other carriers that need that distribution a non-zero sum game for all players.[15]

Vertically integrated ILECs view local competition as a zero-sum game because entry into their local markets will cost them overall profits and revenues, and they act accordingly. The zero-sum game nature of local competition under the existing regime has caused LEC organizations, as a whole, to treat the market-entry products needed by CLECs as nuisances forced on them by telecommunications legislation and regulations. The overall approach of the ILEC negotiation teams is that their job is "to give up as little as possible to meet the requirements of the Act." This minimalist approach has resulted in negotiations that are *not* characteristic of commercial transactions.

In a commercial transaction, *both* parties are *commercially* better off with the deal struck than they are without it.[16] The seller voluntarily sells more and the buyer buys more because both parties expect the transaction to result in an increase in the overall profitability for both of their firms. Under the LoopCo Plan, interconnection negotiations will more closely resemble a commercial transaction where a deal is struck because both parties benefit. LoopCos will not have the conflict of interest that ILECs today experience from the business lost through the sale of unbundled loops. LoopCos will *only* increase revenue and profits by selling more loops to more LECs on a nondiscriminatory basis because each loop sold will result in a positive contribution to a LoopCo's bottom line. LoopCos will measure their profitability only by the effects of sales on their own profitability, and not by their effects on the ILEC.

In contrast, the current "command" regulation-based interconnection tug-of-war negotiations are characterized by the proverbial horse who is led to water, but cannot be made to drink. ILECs, taking the most rational approach under the circumstances, attempt to commit to as little as possible because (1) they know that the success of their CLEC competitors will mean a loss in overall revenue and profits for their own retail operation and (2) serving the critical needs of the CLECs requires an investment that will have a negative cash impact on the firm (described in point 1).

In other words, there is a fundamental structural problem with the current arrangement. (See Figure 1.) The ILEC, the basic entity on which the Telecom Act relies to provide the most critical components to its competitors, has a disincentive to be responsive to the needs of new entrants in the competitive telecommunications industry. No probative economic evidence has ever been presented showing that, under the Telecommunications Act of 1996, ILECs will benefit financially in the long term from serving new entrants to the telecommunications industry, as opposed to their own retail operations.

The financial and operational separation of the LoopCo from the ILEC also more clearly delineates the lines of responsibility between the LoopCo and all other firms that must depend on it. The simpler and clearly visible interfaces between the LoopCo and others makes the quantification and policing of discrimination involving the spun-off LoopCo much simpler than for a vertically integrated company. In the current situation, it is difficult, if not impossible, to make comparisons between how the vertically integrated ILEC provides local distribution to itself versus how it does so to others because there is no clear operational and organizational dividing line between the ILEC's local distribution and its other operations.

Thus, defining what constitutes "discrimination" *vis a vis* others under the Telecommunications Act—not surprisingly—is the epicenter of much of the debate and the requirement for the detailed regulations.

Equalizing Local Distribution Economics

Competition in all market segments requires new entrants to be able to enter the market on a ubiquitous basis.[17] Congress, in passing the Telecommunications Act of 1996, recognized that it was unreasonable to expect local competition to develop by the building of redundant parallel local networks by new entrants on a massive scale. For all new entrants to be able realistically to enjoy the same *benefits* of the economies of scale in local distribution that the ILEC does, the local distribution facilities that are currently under the control of the ILEC need to be made readily available for use by new entrants on a nondiscriminatory basis *in all dimensions.*

As noted above, attempts to define the parameters of what constitutes discrimination between the ILEC distribution provided to the CLEC versus that which the vertically integrated ILEC provides to itself have proven to be impossible. Despite their well-intentioned efforts, the FCC and the state PUCs still have not successfully captured all the dimensions of defining equality between intra-corporate ILEC local distribution-based transactions versus inter-corporate local distribution-based transactions between the ILEC and CLEC.

For example, the relatively simple issue of equality of pricing (in both a long-run and short-run horizon) where the ILEC is vertically integrated with the local distribution is impossible because there can be only a single price for the sale of an unbundled element to unaffiliated carriers. The vertically integrated firm experiences implicit prices that are multidimensional, reflecting the short-term and long-run marginal costs of the products it provides to itself. These multidimensional implicit prices for intra-corporate transactions are difficult, if not impossible, to fully reflect in an agreement that sets forth explicit prices for inter-corporate transactions between two different firms. Thus, not surprisingly, there has been an extensive and irreconcilable debate under the current market structure centering around *the* "price" for unbundled loops. Even if all of the dimensions of costs were somehow captured in explicit prices, what does it mean for the ILEC to "pay itself" the same price as a competitor pays the ILEC?—the former is a non-cash, non-shareholder-value-affecting transaction, while the latter involves real cash flowing between one balance sheet (for which the new entrants' investors have an interest) and the ILEC's balance sheet (for which the ILEC's investors have an interest).

Equality of performance (e.g., time for delivering an unbundled loop) is also impossible to quantify because the vertically integrated ILEC is difficult to compare to the CLEC (i.e., the new entrant). For example, each of the local loops of the ILEC's distribution are pre-connected to the ILEC's local switch. So, in most cases, each time an ILEC turns up a customer, the ILEC need only "turn on" the dial-tone at its switch—a physical activity that can be done in a matter of minutes. But, if a CLEC seeks to use the same unbundled elements, the ILEC—by design—often continues to use a manual, labor-intensive process that takes no less than five days for small numbers of lines, and even longer for larger numbers of lines. Thus, the ILEC, by systematic design approaches, has created a preference for itself. Not surprisingly, the ILEC's defense for this particular discrimination is that it is not a proper comparison and, in turn, the ILECs argue that no discrimination exists. Of course, if the ILEC invested in automated loop reconfiguration equipment, customers of both the ILEC and CLEC could be turned on in the same timeframe. But, the vertically integrated ILEC has no incentive to make these investments in automation—finding investments in lawyers and lobbyists to argue away the discrimination issue more cost effective and profitable.

Under the LoopCo Plan, the spun-off ILEC and new entrants would be treated equally in all respects by the LoopCo, because the ILECs and new entrants would be in the same position in all respects.

LoopCo Plan Details[18]

The LoopCo plan, illustrated in Figure 2, simply calls for spinning off the following into separate, unaffiliated LoopCo companies in each Tier 1 serving area:

- unbundled local loops (including all interconnecting equipment in the Central Office (CO), Main Distribution Frame (MDF), and connections/wiring at the customer premises),[19]
- local central office building structures which serve those unbundled local loops (LoopCo would lease collocation[20] space in those wire centers to the ILEC for the ILEC's central office and tandem switches[21] and its transmission equipment at the same recur-

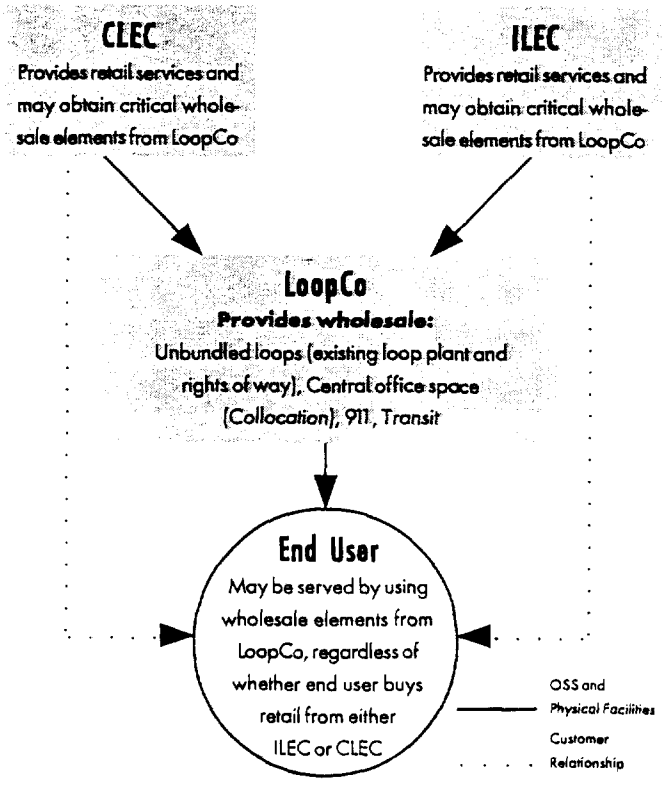
ring and nonrecurring charges, and on the same terms and conditions, that LoopCo offers collocation to the CLECs),

- 911 services for connection to PSAPs[22] (including the connections to the PSAPs and the 911 router(s) in each LATA),
- white pages publication (which would involve publishing generic white pages for the area served by the LoopCo), and
- tandem transit service (i.e., a switch for exchanging traffic only between the various local exchange carriers, including new entrants, at a uniform rate).

The LoopCo would assume ownership and control of only those elements listed above, which are currently owned by the ILEC, along with any support systems required to provide them. The need to limit the facilities and support systems obtained and offered by LoopCo is driven by the need to sever only those identifiable sources of long-term market power from the "competitive firms," such as the post-spin-off ILECs and new local entrants. If the LoopCos were allowed both to retain these long-term sources of market power and to participate in competitive portions of the industry, the LoopCos would be placed in a compromising conflict-of-interest situation where they would be competing with carriers who purchase facilities from them. Thus, LoopCo offerings must, by design, be exclusive of offerings which place them in a position of competing with their carrier customers in the near term.

Figure 2

LoopCo Restructuring



The limited set of critical elements offered by LoopCos constitutes those portions of the unbundled element set that are natural monopolies[23] and, therefore, are unlikely candidates for potential competition on a ubiquitous basis in the reasonably foreseeable future (i.e., five years or more).[24] Moreover, spinning off these elements is a relatively easy task because the local loops and switch building are typically designed and maintained separate and apart within the existing ILEC organizations. The ILEC work force that takes care of the loops is typically separate from that which maintains the switches. Similarly, the work force that builds and maintains the building infrastructure where switches are housed is typically separate and apart from the work force that maintains the switches and the interoffice transmission facilities of the ILEC.

The ILEC would purchase the elements offered by the LoopCo on a nondiscriminatory basis through the same automated operational support systems (OSS) available to the CLECs. Thus, the LoopCo proposal also solves the OSS discrimination and performance problems previously described and highlighted in the LCI Petition for Expedited Rulemaking (CC Docket No. 96-98 RM 9101). Using the unbundled elements from LoopCo and from any other available competing source, the ILEC would be able to offer the same set of retail services it currently offers (including switched and special access). This spinoff will have no direct effect on the services offered to end users. They would continue to purchase their services from their current provider in the same manner. This is in contrast to the 1984 AT&T divestiture, which required all end users to receive two bills (one for local and one for long distance) and separately deal with two carriers for their end-to-end telephone services. The ability of the ILEC and its competitors to offer end-to-end bundled services under the LoopCo plan is one of its key features.

LoopCo would be allowed to sell its offerings only to certified local exchange carriers. LoopCo would be required to price and provide all offerings on a nondiscriminatory basis, thereby providing equitable and fair treatment to the ILECs and other certified local exchange carriers alike. Because

there is a clear and well-defined relationship between the LoopCos and ILECs and CLECs, discrimination *vis a vis* ILECs over CLECs by the *LoopCo* could be easily *defined* and easily *policed*.

LoopCo will only be able to increase its overall revenue and profitability by better serving the LEC (i.e., ILECs and CLECs) industry. Its investment and sales incentives will be dominated by a desire to profit from selling loops (its core product), as compared with vertically integrated ILECs, whose sale and investment incentives are dominated by the profitability of their retail services—which are cannibalized by sales of loops to retail competitors. With loops as its core "bread and butter" product, LoopCos will have the incentive to optimize operations for providing these elements to all LECs (e.g., automating the loop conversion process so as to treat all LECs equally), rather than to treat these offerings as a sideshow—as the ILECs have done and will continue to do under the current regime. Moreover, LoopCos can be further inclined toward efficiency and proficiency in serving the competitive LEC community if they are subject to a properly structured "market rules" regulatory scheme (e.g., de-averaged rate caps on the uniform price for each type of local loop within an MSA and with emphasis on cost justification for regulating rate differences, rather than rate levels). Unlike the vertically integrated ILECs, LoopCos can profit from such efficiencies, yet still be subject to downward price pressure caused by fringe local distribution competitors. Market rules imposed on LoopCos, such as uniform rates across MSAs and fixed relative rate structures, would allow the pressure of the fringe competitors to be leveraged to maintain control on prices for all segments of the market.[25]

Meanwhile, the ILECs, after having spun off the critical elements needed by their competitors, can be subject to reduced regulation (e.g., a simplified market rules approach) or, where appropriate, no regulation. This removal of unnecessary regulation from the post-spin-off ILEC will further enhance ILEC shareholder value by allowing the ILEC to better optimize its remaining operations to provide the retail services it currently offers. Moreover, once the spin-offs are successfully implemented in an RBOC Tier 1 Company serving area, that RBOC will have complied with Section 271 of the Act[26] and would be allowed to provide in-region long-distance service. Consideration should be given to going further to allow such long-distance service to be offered without a separate subsidiary by the ILEC once the LoopCo spin-off is successfully implemented.

FCC's Regulatory Authority

Just as it has jurisdiction under the Telecommunications Act over all dedicated point-to-point transmission line services ("private lines") and consumer telephone equipment, even though used only part of the time for interstate calling, the FCC can assert jurisdiction over all of the facilities offerings of the LoopCos based on *Louisiana Pub. Service Comm v. FCC.* [27] Under *Louisiana*, the FCC has jurisdiction over all telecommunications "non-severable" facilities that can be shown to be used for interstate calling where (1) it is impossible to separate interstate and intrastate components of these facilities and (2) state regulation would negate the FCC's lawful authority for regulating these facilities. If the FCC determines that its regulatory objectives require that the interstate portion of a local loop be offered through a separate firm, it can require that the entire loop be offered by a separate firm—even if that loop is sometimes used for within-state calling and even if the state objects to the spin-off arrangement. Under *Louisiana*, the FCC would have jurisdiction over the rate components of, in addition to the terms and conditions for interconnection with, the local loop facilities of LoopCos. Similar arguments can be made for FCC regulation of other spun-off components proposed to be placed in LoopCos.

With loops as its core "bread and butter" product, LoopCos will have the incentive to optimize operations for providing these elements to all LECs . . .

Like its authority to spin off non-severable, terminal equipment into a separate subsidiary of the predivestiture Bell System in the *Computer Inquiry II*,[28] the FCC continues to have the legal authority to

spinoff into a separate company key wholesale facility components of ILECs into LoopCos, as proposed here. The need for a separate LoopCo firm in the case of all Tier I ILECs is the same as it was for the FCC to spin off assets of Tier I companies under *Computer Inquiry II* decision—namely, that nonstructural solutions are inadequate under the current circumstances to achieve competition in an identified portion of the telecommunications market. The LoopCo plan will strengthen the case for local competition with less overall regulation. The *Computer II* and *Louisiana* case law, which supports the FCC's authority to spin off assets of the firm into other firms, is undisturbed to this day and remains in full effect. ▲

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[1] *See* Letter of Roy L. Morris, USONE, to Chairman Reed Hundt, FCC, *Recommendation for Commission Actions Critical to the Promotion of Efficient Local* Exchange Competition, CCBPol. 97-9 (Aug. 11, 1997)(http://members.aol.com/RoyMII/LoopCo).

[2] *See, e.g.*, Richard Pierce, Jr., *Antitrust Policy in the New Electricity Industry*, ENERGY LAW JOURNAL, Vol. 17:29 (1996) at 29, 39-48, 53-58.

[3] Telephone Number Portability, FCC CC Docket No. 95-116 (March 11, 1997).

[4] *It is a common misconception that all returns are created equal and that large* estimated returns can justify large investments. However, modern finance distinguishes between the quality of returns by the risks associated with them. [The so-called Capital Asset Pricing model is at the core of these comparisons. *See, e.g.*, BREALEY and MYERS, PRINCIPLES OF CORPORATE FINANCE, 3rd Edition, McGraw Hill (1988) at Chapters 7 - 9). A comparison of *risk-adjusted* returns (*i.e.*, returns to which large discount rates are applied to highly uncertain returns) shows that the more certain, albeit smaller, returns of some ventures are often *better* investments than ventures which promise high, but uncertain returns. *Id.* at 9-4.

[5] An unbundled loop is the connection between each existing telephone subscriber of the ILEC and the central office building where the ILEC has a local switch. A local switch makes connections between local loops connected to that switch and between local loops and transmission trunks to distant points.

[6] The Central Office (CO) is the building where the unbundled loops terminate and the ILECs house their local switch equipment. The CO also houses the Main Distribution Frame (MDF), which is a large framework on which unbundled loops are terminated in the central office and from which connections to other equipment in the central office (e.g., local switch equipment) are made.

[7] This was illustrated recently by the merger of Bell Atlantic and NYNEX. Rather than compete with NYNEX on a targeted basis and enter through duplication of the NYNEX local distribution network, Bell Atlantic found it was a better investment to buy the incumbent. The Bell Atlantic/NYNEX merger demonstrates that it is Bell Atlantic's strategic viewpoint that the ILEC (which controls the local distribution network in its territory) is better positioned to compete than new entrants (who must depend on that ILEC local distribution network).

[8] Telecommunications Act (47 USC) as amended on February 8, 1996 contains the provisions which were to promote local telephone competition, and once that is underway, allow the Regional Bell Operating Companies (RBOCs) into the competitive long distance business. Sections 251 and 252 of the Telecommunications Act (47 USC §251 and §252) sets forth a number of requirements for interconnection between LECs. Section 152(b) of the Telecommunications Act (47 USC 152(b)) provides that intrastate services shall be regulated by the state Public Utility Commissions or PUCs. Section 271 of the Telecommunications Act sets forth the conditions which were alleged to have opened up the local monopoly market such that the ILEC-RBOCs were to be allowed to provide long distance to customers in their operating regions. The RBOCs or Regional Bell Operating Companies are the ILECs which were once part of the Bell System prior to the divestiture of AT&T from its local telephone companies in 1982. (Ameritech, BellSouth, NYNEX, Pacific Bell, Southwestern Bell, US West).

[9] An incumbent local exchange company (ILEC) is the established local telephone company which provides virtually all of the local telephone service in its region (e.g., Ameritech, Bell Atlantic, BellSouth, NYNEX, Southwestern Bell, Cincinnati Bell, Pacific Bell, McLeodUS A). A competitive local exchange carrier (CLEC) refers to a new local telephone company (e.g., McLeodUSA, Winstar, TCG, ICG) that is entering the local market in order to compete with the incumbent local telephone company. The term "local exchange carriers," including all ILECs and CLECs.

[10] *Iowa Utilities Board v. FCC*, 1997 SL 403401 (8th Cir. 1997), which partically overturned the FCC's rules regarding interconnection between ILECs and CLECs (Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, FCC 96-325, adopted August 8, 1996).

[11] The spin-off could be in the form of a noncash transaction resulting in two companies, one being the *LoopCo* holding the unbundled loops, etc of the Tier I ILEC and the other company holding the remaining assets of the Tier I ILEC (including the interoffice transmission, tandem switches, of the Tier I ILEC). The transaction can be done in such a way as to leave the shareholders of the current ILEC's whole (e.g., the shares of the newly formed *LoopCo* are issued as dividends or return of capital to the existing ILEC shareholders, or the cash raised by the IPO of the newly formed *LoopCo* is used to buy back the shares held by the ILEC, leaving the ILEC with cash equal to the market valuation of its *LoopCo*).

[12] In stagnant businesses (such as the telecommunications industry prior to the deregulation era), vertical integration with a lack of focus might have been a

more profitable strategy because the incumbent had a long time to learn about changes in the technology and to develop new market strategies. In a less dynamic market, there is adequate time for the incumbent to adapt without losing market share. Not surprisingly, incumbents typically use regulation to slow down changes in the market to retard the environment's advancements to suit their own limited abilities to adapt to change.

[13] A firm which seeks to satisfy a customer's need for "one stop shopping" need not be the underlying provider of all the services or products to that customer. Through alliances, franchising, and resale, such firms can provide customers the convenience of "one stop shopping" without having to make the investments necessary to, and suffer from the diversions of, entering into other lines of businesses.

[14] As a second best solution, each LoopCo could be minority owned by a certified LEC, but the majority of its ownership and any control must be held by non-LECs or their affiliates.

[15] Zero-sum game is used here to refer to a transaction in which one party must lose overall in order for the other to gain overall.

[16] *See, e.g.,* Morris and Preece (FCC), *Negotiating for Improved Interconnection: The Incentives to Bargain,* Office of Plans and Policy Working Paper No. 7, OPP Working Paper Series (April 1982).

[17] Ubiquitous entry is used here to refer to the ability of CLECs to enter the local market and to provide service to all segments of the market and maintain an overall profitability in each major market segment, with or without the presence of a "universal service" subsidy scheme.

[18] A scheme similar to the LoopCo plan was discussed in J. Duvall: Evolution of Competition in the Market for Local Telecommunications Services: A Proposal for Industry Organization in the 21 st Century, Presented Before USTA Industry Consolidation Conference (June 1987); cited and discussed in BOLTER, MCCONNAUGHEY, and KELSEY, TELECOMMUNICATIONS POLICY IN THE 1990'S AND BEYOND,(M.E. Sharpe, Inc., 1990) at 384.

[19] A customer's premises refers to the location where the telephone user (e.g., residential or business customer) is physically located.

[20] Collocation is a term referring to the placing of various LEC equipment in the central office.

[21] Tandem Switch refers to a switch that connects transmission links connecting to other switches.

[22] PSAP is a public safety agency operator (e.g., the operator which answers the 911 calls for each public safety agency, such as the police, fire, and ambulance services).

[23] In a "natural monopoly," large scale production makes it possible for a single firm to produce the entire output of the market at lower average cost than a number of firms each producing a smaller quantity. BAUMOL and BLINDER, ECONOMICS PRINCIPLES AND POLICY, 4th Edition (Harcourt Brace Jovanovich, 1986) at 215.

[24] Examples of ILEC facilities that would not be spun off are central office switches, interoffice trunks, operator services facilities and the support systems for these facilities. Compared to the capital intensive and sunk cost nature of local loops and other LoopCo facilities, these facilities that remain with the ILECs are relatively easily obtained or built, and in many cases their costs are not for the most part geographically sunk.

[25] Morris and Preece (FCC), Roadmap for Deregulating AT&T, Policy Research in Telecommunications Proceedings from the Eleventh Annual Telecommunications Policy Research Conference (1984) at 79.

[26] As noted above, Section 271 of the Telecommunications Act of 1996 contains the provisions that control when an RBOC is allowed in the long distance business in its own territory. 47 U.S.C. § 271.

[27] 476 US 355, 375-376, n. 4 (1986).

[28] *Computer Inquiry II,* Amendment of Section 64.702 of the Commission's Rules and Regulations, 77 FCC 2d (1980) (Final Decision), *reconsideration,* 84 FCC 2d 50 (1980), *further reconsideration,* 88 FCC 2d 512 (1981), *aff'd sub nom., CCIA v. FCC,* 693 F2d 1983 (D.C. Cir. 1982).